

**Letter Report: Revised Questionable Refund
Program Procedures Were Not Consistently
Implemented**

January 2001

Reference Number: 2001-40-025

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

January 2, 2001

MEMORANDUM FOR CHIEF, CRIMINAL INVESTIGATION

A handwritten signature in black ink that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report - Revised Questionable Refund Program
Procedures Were Not Consistently Implemented

This report presents the results of our review of the revised Questionable Refund Program (QRP) procedures. In summary, we found that the Internal Revenue Service (IRS) did not consistently implement revised QRP procedures in two of five locations reviewed. Because these locations made changes to taxpayers' tax account information without providing proper notification to the taxpayers, the taxpayers' rights and the government's interest were not protected. The Technical and Miscellaneous Revenue Act of 1988,¹ states that taxpayers who overstate a claim for the Earned Income Credit should be provided a deficiency notice. The primary purpose of the Notice of Deficiency is to lead to the establishment of a deficiency assessment and the ability of the taxpayer to contest that liability before collection.

Taxpayers were not provided with proper notification before information that was determined to be false was removed from their tax accounts, nor were taxpayers notified of their rights to contest the IRS' decision to remove this information. Further, the government's interest was not protected, as a result of the IRS not issuing required notices to taxpayers.

Our recommendation will provide a measurable benefit to tax administration by protecting taxpayer rights and entitlements. IRS management agreed with the recommendation

¹ Technical and Miscellaneous Revenue Act of 1988, § 1015(r), 26 U.S.C. §§ 6201(a)(3), 6211, 6213, and 6201 note (1994 & Supp. IV 1998).

contained in the report. IRS management's comments and additional Office of Audit comments have been incorporated into the report where appropriate, and the full text of their comments is included as in Appendix IV.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

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Objective and Scope

The overall objective of our audit was to determine whether the IRS effectively, efficiently, and timely developed and implemented newly mandated QRP procedures.

The overall objective of our audit was to determine whether the Internal Revenue Service (IRS) effectively, efficiently, and timely developed and implemented newly mandated Questionable Refund Program (QRP) procedures. These procedures included notifying taxpayers before changing their tax accounts.

To accomplish our objective, we:

- Reviewed the IRS Office of Chief Counsel decision dated February 4, 1999, which required the IRS to issue notices to taxpayers before any confirmed false information was removed from their tax accounts.
- Analyzed revised program procedures prepared by the National Headquarters Service Center Examination and Criminal Investigation functions.
- Interviewed employees from the National Headquarters Criminal Investigation and Service Center Examination functions, Fraud Detection Centers,¹ Service Center Examination offices, and the IRS Office of the Chief Counsel.
- Used a computer program to identify 38,141 individual tax accounts from tax years 1995 to 1998 that were under review by the Criminal Investigation function (all 10 offices) as of October 1999. From this universe, we used a random number generator to select 6 judgmental samples meeting the following conditions:
 - 62 of 224 cases that were processed by 5 Fraud Detection Centers after the April 1, 1999, directive to cease processing to determine if the IRS adhered to the revised QRP procedures.

¹ Fraud Detection Centers were formerly referred to as Criminal Investigation Branch offices.

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- 80 of 9,681 cases from 2 Fraud Detection Centers to determine if they were accurately accounted for and recorded in the Fraud Detection Centers' paper inventory records.
- 80 of 3,320 cases from 2 Fraud Detection Centers to determine if they were included in the Fraud Detection Centers' computerized inventory system.
- 65 of 4,455 cases from 2 Fraud Detection Centers to determine if they were timely, accurately, and properly recorded, authorized, and processed.
- 60 of 3,480 cases with expired or imminent statutes from 2 Fraud Detection Centers to determine if they were processed properly.
- 6 of 6 cases that involved taxpayer correspondence from 2 Fraud Detection Centers to determine if they were processed timely.

We performed primary audit work at the Andover and Brookhaven IRS tax processing centers, with additional testing at the Atlanta, Austin, and Fresno tax processing centers.

We performed primary audit work at the Andover and Brookhaven IRS tax processing centers, with additional testing at the Atlanta, Austin, and Fresno tax processing centers. The audit was conducted from September 1999 through June 2000 in accordance with *Government Auditing Standards*. Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List.

Background

The QRP program is designed to detect and stop the payment of false refund claims on income tax returns.

The IRS has a nationwide multi-functional program, the QRP, designed to detect and stop the payment of false refund claims on income tax returns. For example, some false refund claims are identified by the Criminal Investigation offices through verification with the taxpayer's employer of wages and federal tax withholding reported by the taxpayer on the tax return. If the contacted employer stated that the taxpayer was not an employee or that the wages and/or

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federal tax withholding were not accurate, the Criminal Investigation employees would correct the taxpayer's tax account. Federal tax withholding would then be reduced and, based on the revised income level, the amount of the taxes owed would be increased and, if applicable, the Earned Income Credit (EIC) amount would be reduced or eliminated.

IRS statistics show that from January through September 1999, the QRP was responsible for the detection of approximately \$108 million in fraudulent refunds claimed by individual taxpayers.

The Technical and Miscellaneous Revenue Act of 1988,² states that taxpayers who overstate a claim for the EIC should be provided a deficiency notice. The primary purpose of the Notice of Deficiency is to lead to the establishment of a deficiency assessment and the ability of the taxpayer to contest that liability before collection.

In February 1999, the IRS Office of the Chief Counsel issued a memorandum stating that in situations where taxpayers overstate a claim for federal tax withholding, a claim disallowance notice should be issued. The Notice of Claim Disallowance is issued to advise the taxpayer of the denial of the credit and claim for refund and to provide the taxpayer rights to contest the IRS' determination.

Another purpose of issuing the Notice of Claim Disallowance is to protect the government's interest. For example, until a Notice of Claim Disallowance is issued, the limitation period for filing suit against the IRS to obtain the refund remains open indefinitely. Once the notice is issued, the taxpayer has 2 years to seek judicial resolution.

² Technical and Miscellaneous Revenue Act of 1988, § 1015(r), 26 U.S.C. §§ 6201(a)(3), 6211, 6213, and 6201 note (1994 & Supp. IV 1998).

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The IRS Office of the Chief Counsel issued a memorandum stating that to protect taxpayer rights and comply with tax law, the IRS needed to revise the QRP procedures.

Revised QRP procedures should have been implemented by the IRS in September 1999.

The IRS Office of the Chief Counsel memorandum also stated that procedures for processing QRP cases needed to be revised to protect taxpayer rights and to comply with tax law.³ The revised procedures, as well as the IRS Office of the Chief Counsel memorandum, require the IRS to issue notices (Notice of Deficiency or Notice of Claim Disallowance) to taxpayers before removing information that was determined to be false from the taxpayers' accounts. The IRS determined that this would involve the Fraud Detection Centers transferring the cases to the Service Center Examination function for the proper notices to be issued.

On April 1, 1999, Criminal Investigation National Headquarters issued a message to all Fraud Detection Center Chiefs instructing them to stop processing tax accounts in the QRP until revised procedures could be developed and issued.

Revised QRP procedures were issued by the National Headquarters Service Center Examination and Criminal Investigation functions in September 1999. The new procedures were designed to ensure that the government's interests were protected while preserving all of the taxpayers' rights. This was accomplished by requiring the Fraud Detection Centers to transfer tax accounts (with information that was determined to be false) to the Service Center Examination function for processing. The Service Center Examination function issues either a Notice of Deficiency or a Notice of Claim Disallowance to the taxpayer stating that the IRS has identified false information on his/her tax return. If the taxpayer does not respond to the notice, the Service Center Examination function removes the false information from the taxpayer's tax account.

³ Technical and Miscellaneous Revenue Act of 1988, § 1015(r), 26 U.S.C. §§ 6201(a)(3), 6211, 6213, and 6201 note (1994 & Supp. IV 1998).

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Results

Interim guidelines and revised QRP procedures, to better protect taxpayer rights, were not consistently followed in two of five Fraud Detection Centers reviewed. As a result, the IRS did not protect taxpayer rights and the government's interest as directed by the IRS Office of the Chief Counsel's guidance.

During the audit, we found locally correctable issues regarding the control and processing of the QRP cases, which we informally communicated to local Criminal Investigation and Service Center Examination management. We also determined that while the Criminal Investigation and Service Center Examination Headquarters offices took 5 months to develop and formally issue the revised procedures, the delay had no material adverse taxpayer effect.

**The Internal Revenue Service Did Not
Consistently Implement the Revised
Questionable Refund Program Procedures**

The revised QRP procedures issued to protect taxpayer rights were not consistently implemented.

Protecting taxpayer rights in Fraud Detection Centers

The IRS did not consistently implement the revised QRP procedures in 20 of the 62 cases we reviewed. After issuance of an April 1999 directive to the Fraud Detection Centers to stop processing tax accounts in the QRP, two Fraud Detection Centers continued to remove false information from some tax accounts. Furthermore, the two offices did not implement the revised QRP procedures that were issued in September 1999. These offices did not transfer all the QRP cases to the Service Center Examination function so that the proper notifications could be issued to the taxpayers before false information was removed from their tax accounts.

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As a result, taxpayers were not provided notice before information that was determined to be false was removed from their tax accounts nor were taxpayers notified of their rights to contest the IRS' decision. Further, the government's interest was not protected because the IRS did not issue the required notices to taxpayers. For example, until a Notice of Claim Disallowance is issued, the limitation period for filing suit against the IRS to obtain the refund remains open indefinitely. Once the notice is issued, the taxpayer has 2 years to seek judicial resolution.

Standards for Internal Control in the Federal Government provide that assignment, review, and approval of a staff's work should result in proper processing of transactions and events, including following approved procedures and requirements.

The structure of the managerial oversight of the Fraud Detection Centers, at the time, contributed to the problems the IRS had with the implementation of the new QRP procedures. More specifically, "The CI [Criminal Investigation] Chief of the Office of Refund Fraud [National Headquarters Criminal Investigation, Refund Crimes] does not have direct authority over the CIBs [Criminal Investigation Branches, now Fraud Detection Centers] that implement the program."⁴

We also noted several locally correctable conditions regarding the control and processing of QRP-identified cases.

Locally correctable issues

During the audit, we found several locally correctable issues regarding the control and processing of QRP-identified cases. These conditions were informally communicated to local Service Center Examination and Criminal Investigation management.

⁴ William H. Webster, *Review of the Internal Revenue Service's Criminal Investigation Division*, page number 99 (1999). This report was issued in response to a request from the IRS Commissioner for an independent review of the Criminal Investigation function.

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For example, one Service Center Examination office had not issued the necessary notifications to 174 taxpayers whose returns had been identified in the QRP. Instead, the Examination office had returned the cases to the Criminal Investigation function without action because it did not have procedures for these types of QRP cases. After the Treasury Inspector General for Tax Administration informed the local managers that their National Headquarters had subsequently issued procedures that covered these cases, they retrieved the cases from the Criminal Investigation function and properly processed them.

Recommendation

We recommend that the Chief, Criminal Investigation, ensure that the five Fraud Detection Centers, not visited during this audit, are processing QRP cases according to the National Headquarters procedures.

We recommend that the Chief, Criminal Investigation ensure that the five Fraud Detection Centers, not visited during this audit, are processing QRP cases according to the National Headquarters procedures.

Management's Response: IRS management agrees the National Office procedures provide for the proper handling of QRP cases. The importance of following the procedures was stressed at all ten Fraud Detection Centers (FDCs) during training conducted by the Headquarters Staff and through training programs within the FDCs in calendar year 2000. IRS management will continue to emphasize and monitor this topic during Refund Crimes annual update training, for all FDCs, Refund Crimes assistance visits, and Criminal Investigation peer reviews.

Office of Audit Comment: We disagree that IRS management's corrective actions were completed as of January 2000. As of the date of this report, Refund Crimes assistance visits to assess whether QRP cases were processed according to the National Headquarters procedures were not performed for the five FDCs not visited during our audit.

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Conclusion

Because the IRS tax processing centers did not comply with the Chief Counsel memorandum and the revised QRP procedures, taxpayers' rights and the government's interest were not protected. Taxpayers were not provided notice before information that was determined to be false was removed from their tax account nor were taxpayers notified of their rights to contest the IRS' decision. Further, the government's interest was not protected because the IRS did not issue the required notices to taxpayers.

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Appendix I

Major Contributors to This Report

Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs)

Michael Phillips, Director

Donald Butler, Audit Manager

Russell Martin, Acting Audit Manager

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Appendix II

Report Distribution List

Commissioner C
Commissioner, Wage and Investment Division W
Director, Compliance W:CP
Director, Refund Crimes CI:RC
Director, Legislative Affairs CL:LA
Director, Strategy and Finance W:S
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
National Taxpayer Advocate TA
Office of the Chief Counsel CC
Office of Management Controls N:CFO:F:M
Audit Liaisons:
 Refund Crimes CI:RC

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Appendix III

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements - Potential; 20 taxpayer accounts impacted; (see page 5)

Methodology Used to Measure the Reported Benefit:

We reviewed 62 of 224 QRP cases processed by 5 Fraud Detection Centers after the April 1, 1999, directive informing these offices to cease processing QRP cases. Out of the 62 cases, we found that 20 cases (32 percent) involving 2 Fraud Detection Centers were incorrectly processed. As a result, the taxpayers were not provided notification before information that the IRS determined to be false was removed from their accounts. This action did not protect taxpayers' rights or the government's interest.

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Appendix IV

Management's Response to the Draft Report

FROM

(FRI) 12:01'00 12:17/ST. 12:16/NO. 3560740491 P 2



CHIEF
CRIMINAL INVESTIGATION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

December 1, 2000

**MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR
TAX ADMINISTRATION**

Mark E. Matthews
FROM: Mark E. Matthews
Chief, Criminal Investigation

SUBJECT: Draft Treasury Inspector General for Tax Administration (TIGTA)
Letter Report—Revised Questionable Refund Program Procedures
Were Not Consistently Implemented—(Ref. #199940112)

Thank you for the opportunity to respond to your draft report dated November 2, 2000. The IRS' Questionable Refund Program (QRP) is extremely important to its compliance initiatives and fraud detection in general. We appreciate your support of our objectives to improve the program.

Protecting government interests, taxpayers' rights, and revenue, are objectives of QRP. To ensure the most effective program possible, Criminal Investigation (CI) conducts annual peer reviews of its programs. The results of these reviews give direction to and improve the changing tax filing environment. During peer reviews conducted in 1999, CI found two of our Fraud Detection Centers (FDCs) were not following the procedures for Master File accounts associated with false returns. The respective findings were documented CI's final review reports, and procedural improvements were made to the program, which continued in all ten of the FDCs for 2000.

We will share the findings of your audit with the ten FDCs to reinforce the need to follow procedures for Master File accounts associated with false returns.

If you have questions about this response, please call Gary D. Bell, Director, Refund Crimes, CI:RC, at (202) 622-7140, or Bill Turner of his staff at (202) 622-7795.
Attachment

cc: Director, Planning & Strategy Section CI:S:PS

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Attachment

Response to Draft Internal Audit Report Review of the New QRP Procedures – (Ref. #199940112) November 2, 2000

Recommendation

We recommend that the Chief, Criminal Investigation ensure that the five Fraud Detection Centers, not visited during this audit, are processing QRP cases according to the National Headquarters procedures.

Assessment of Cause(s):

Two FDC's, formerly Criminal Investigation Branches, did not follow the guidelines for QRP Referrals to Examination, issued in August of 1999.

Corrective Action(s):

We agree the National Office procedures provide for the proper handling of QRP cases. We have stressed the importance of following the procedures at all ten FDCs during training conducted by the Headquarters Staff and through training programs within the FDC's in calendar year 2000. We will continue to emphasize and monitor this topic during Refund Crimes annual update training for all FDC's, Refund Crimes assistance visits, and Criminal Investigation peer reviews.

Implementation Date:

Completed: January 2000

Proposed: _____

Responsible Official(s):

Director, Refund Crimes CI:RC

Corrective Action(s) Monitoring Plan:

We will monitor the corrective actions for this recommendation during peer reviews and program delivery.